Providence
Independent Investment Advisory

The Tide Has Turned

Global Outlook & Strategy

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Co-authors:

Grant Patterson	Chief Investment Officer
Will Porter	Head of Investment Strategy
James Smith	Head of Melbourne

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Global Outlook & Strategy Issue 84
1st Quarter, 2022

1. KEY POINTS

- Inflation awakes from its decades-long slumber
- Interest rates are set to move higher, challenging valuations
- Global growth remains above trend
- Record government debt will hinder longer term growth
- A challenging investment environment with higher volatility
- Many assets are already down quite substantially

The Tide has Turned

There is a regime change underway in investment markets - the re-emergence of inflation after decades of slumber. This will lead to a gradual increase in interest rates and the unwinding of accommodative central bank policy (some of which are still arguably at “emergency settings”). Not surprisingly, this comes at a time of record global debt, stretched valuations and layers of speculative frenzy, the likes of which we have never seen… or have we?

This warrants careful attention to portfolio construction and risk management.

With the tailwind of declining interest rates and unprecedented money supply, asset prices across the board have risen with little regard to the risk undertaken. **This is about to change.** There will be more dispersion of performance across, and within, asset classes along with the risk-adjusted returns of investment managers.

While this is little understood in a bull market, it becomes apparent in a change of regime. Like during the GFC (Global Financial Crisis) when the Fear of Missing Out (FOMO) was quickly replaced by the Fear of Losing Out (FOLO), we are now witnessing a speculative frenzy and distortions within some asset classes will have lasting ramifications for portfolio construction and inflation-adjusted investment returns.

We maintain a positive, yet protective, stance focusing on value, long-term cashflows and a high degree of diversification.

2. Investment Overview

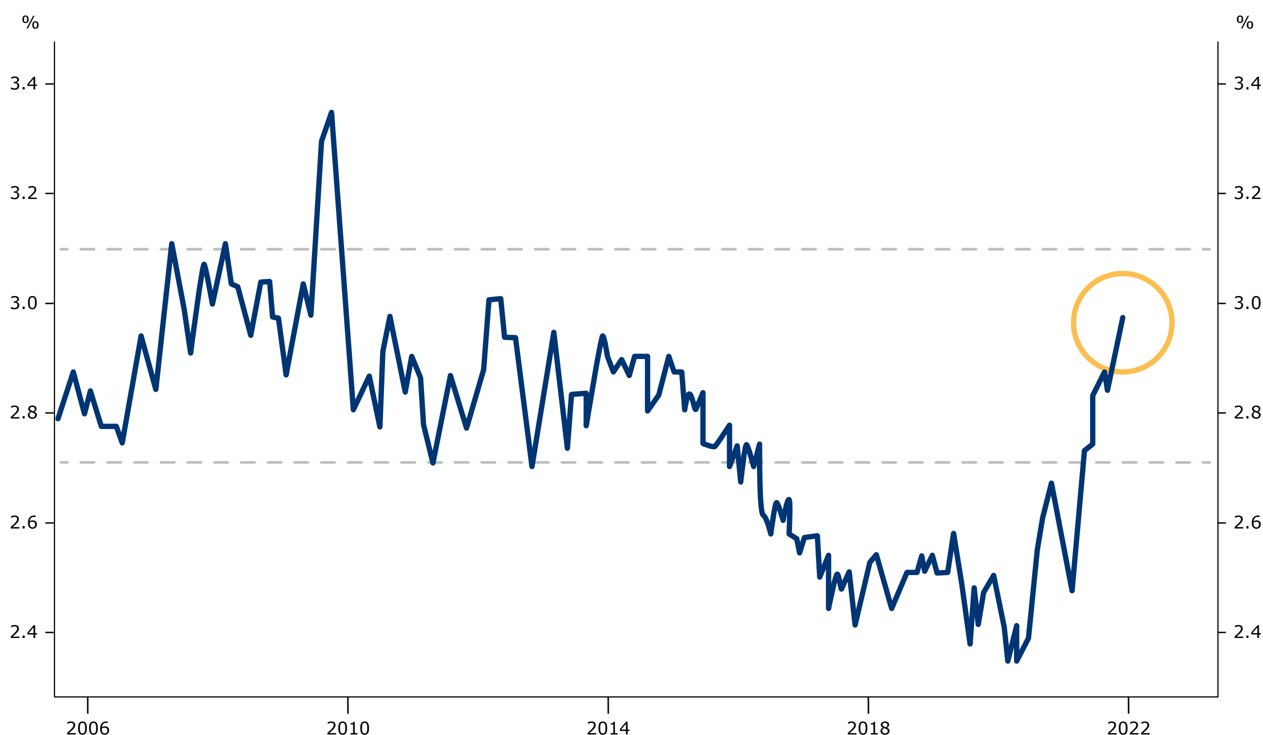
The combination of an ultra-loose monetary policy (low interest rates), quantitative easing (printing of money) and government handouts (fiscal spending) along with pent-up demand and supply chain disruptions, has seen an explosion in the headline inflation rate. Headline inflation is running at ~7% annualised in the US, with the core rate also elevated at 4.9%. Both the market and Federal Reserve are betting on inflation moderating to 2.5-3% after the bottlenecks from Covid-related disruptions subside. Although inflation is likely to moderate from current levels, it is unlikely to be transitory, and we should expect an uncomfortably higher rate in the medium term. Longer term inflation expectations remain anchored (**Figure 1**) at around 3% which seems benign. We believe the market may be setting itself up for disappointment with the inflation rate holding above that level. We also believe that the US 10-year bond yield could reach 2.2% (currently 1.76%) this year and more than 3% in 2023.

Any upward move in longer term inflation expectations will result in a reassessment of the likely bond rate trajectory and current valuations, especially across growth stocks.

This remains the biggest risk to valuations across all asset classes.

Figure 1: Longer term (5-10 year) consumer inflation expectations remains relatively well anchored.

Source: BCA Research



Government debt-to-GDP ratios have risen substantially over the past 20 years due to the fiscal response to the GFC and the COVID-19 pandemic. In the US, the government debt-to-GDP ratio is back to levels only seen at the end of WWII. The UK government has also seen a massive spike in debt (**Figure 2**). Whilst subsiding somewhat in the future, the burden of this debt will be around for generations and any upward move in the bond rate will only add to this burden. This interest payment impost on the back of higher global interest rates is front of mind for investors

and is, in part, reflected in the relatively contained pricing of longer-term bond rates. The current anchoring of lower long-term interest rates is also influenced by the forward forecasts of the US Congressional Budget Office which continues to point to rising debt levels in the future (**Figure 3**).

Figure 2: Government debt in the US and UK has risen dramatically, initially on the back of the GFC and then on the unprecedented fiscal response to COVID-19.
Source: BCA Research

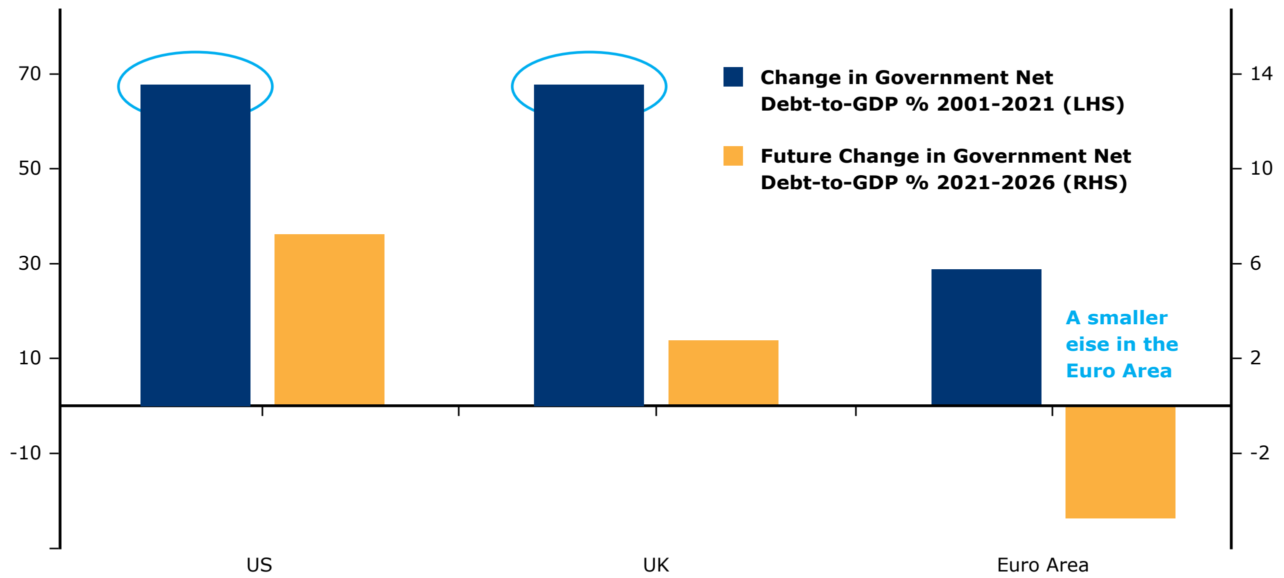
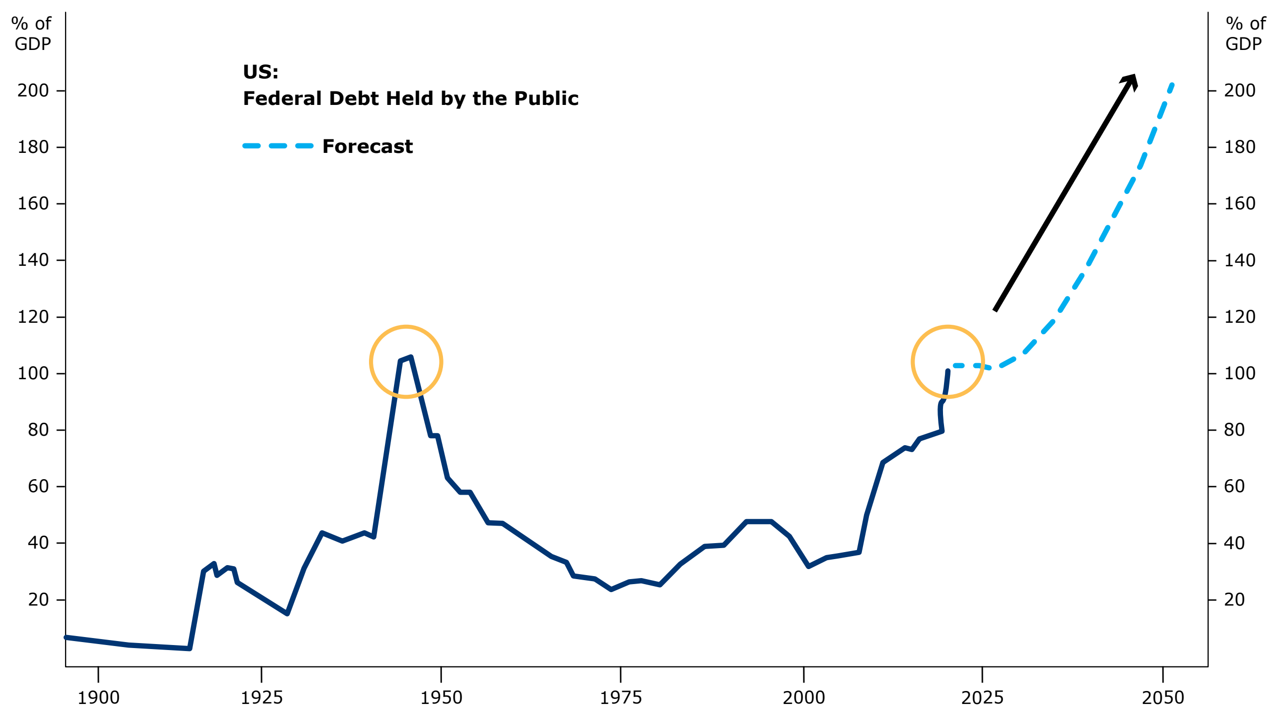


Figure 3: The US Congressional Budget Office prediction for federal debt is rather sobering.
Source: BCA Research



Despite the Omicron setback, global growth is expected to be robust and remain above trend in 2022. Accommodative monetary policy (even if there is a start to the reversal of emergency policy settings) will continue to support corporate earnings. Another positive is that household savings rates, which have exploded over the past couple of years to levels not seen since WWII, (**Figure 4**) provide a favourable consumer demand backstop. The level of personal savings in Australia (also seen in **Figure 4**) is of note, given the rolling lockdowns in key eastern states. This elevated level of savings should ultimately support consumer demand as things slowly normalise and may well support earnings growth into FY23. In addition, household balance sheets in the US are in great shape with debt servicing back to levels not seen since the 60s (**Figure 5**).

Figure 4: Household savings in key developed economies are in a very strong position, helping to provide a favourable demand backstop. Note: Australia also has a supportive backstop as things ultimately normalise.

Source: BCA Research

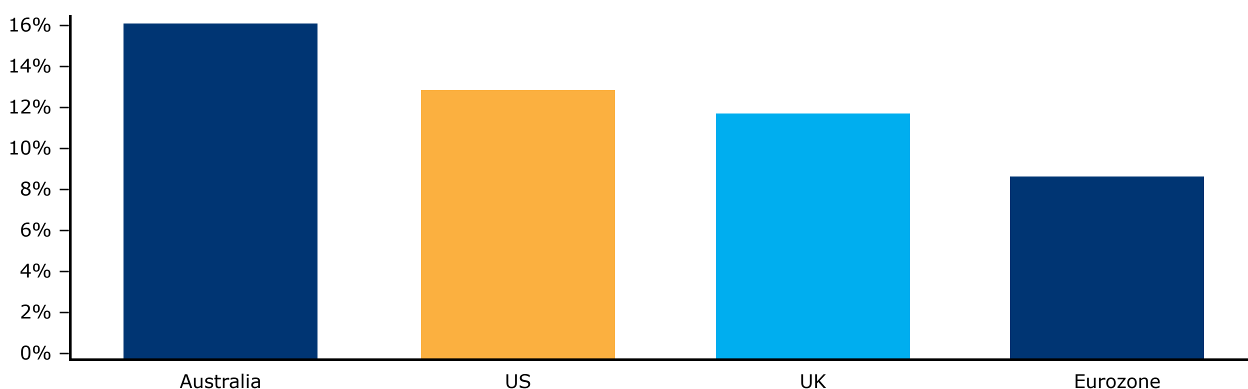
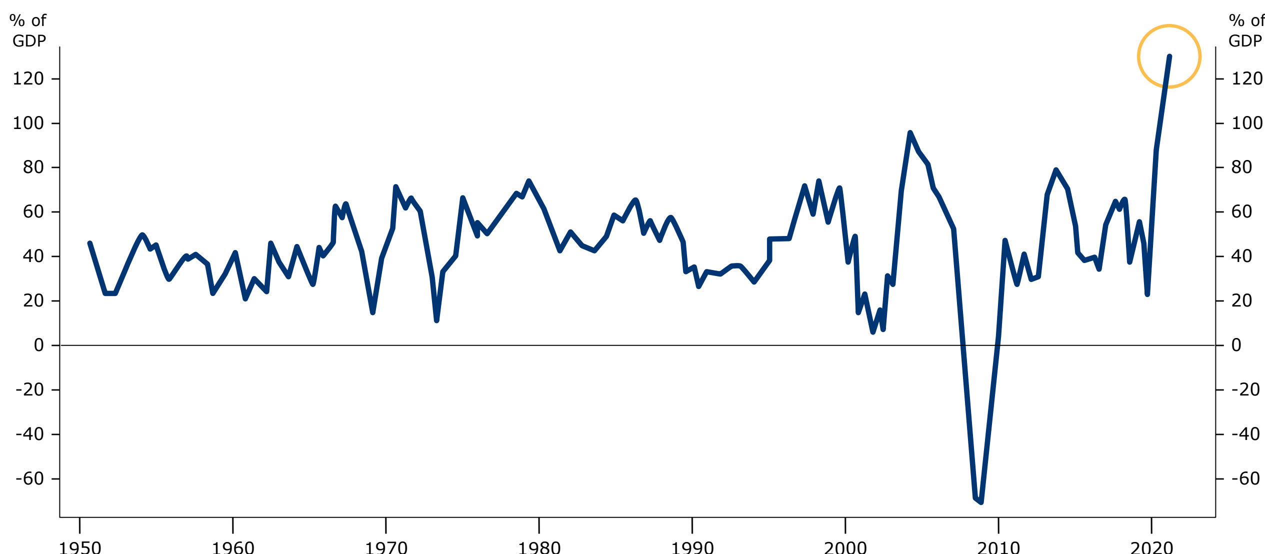


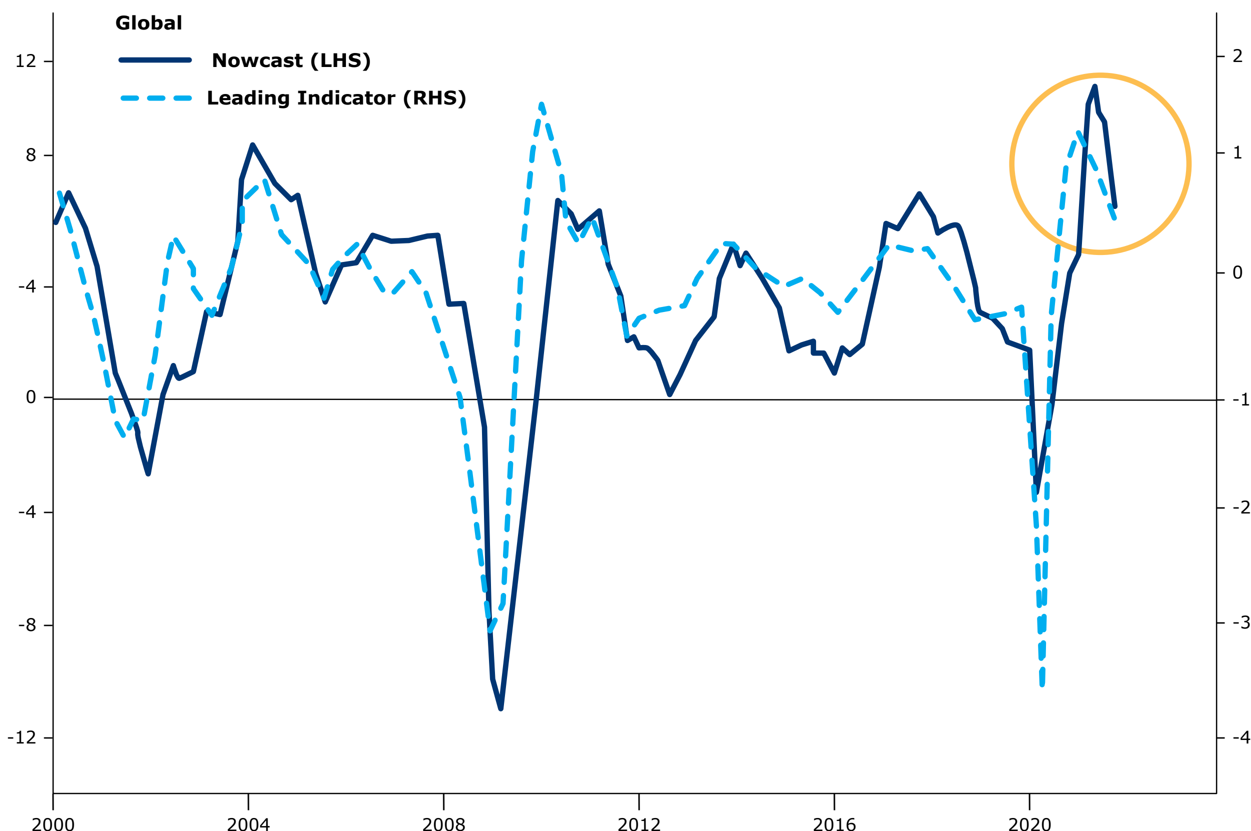
Figure 5: US household net wealth is in a very strong position, helping to provide a favourable demand backstop.

Source: BCA Research



Leading indicators in developed economies, although declining, are still pointing to above trend growth (**Figure 6**). Expect more challenges to the growth outlook as higher interest rates and wage costs ultimately put pressure on margins.

Figure 6: Leading economic indicators*, whilst off recent highs, are coming off extremely elevate levels post the global re-opening.
Source: BCA Research



*The Nowcast indicator (proprietary BCA Research data) measures economic activity and helps predict global industrial production

Chinese real GDP growth, currently at ~4.0% annualised in the December quarter, is the exception and below trend. However, it is expected to rebound towards the 8% level following recent stimulus announcements (including a cut in medium-term lending facilities and the short-term REPO rate). The property sector in China, which accounts for 15-25% of GDP growth, is in complete chaos. Evergrande, China's largest property developer with over 1300 projects across 280 cities, has defaulted on some of its $300bn of debt. The Chinese government crackdown on property speculation has seen land auctions plummet as much as 70%, with many property developers facing collapse.

Pleasingly, despite the enduring lockdowns across the eastern states, Australia's GDP growth is running at 3.9% with an upward bias. As mentioned, excess household savings are running at a very high >15%. Employment growth is very strong, and the unemployment rate has fallen to 4.2%, its lowest level in 13 years. This strength will also put upward pressure on interest rates with a 1.25% cash rate on the horizon for 2023 (there are currently 4 interest rate increases priced by the market over the next year with an additional 3 priced in 2023). An election year will focus Australian markets on a potential change of government, with a "normal" federal election day to be no later than 21 May. Expect daily Covid updates to be closely followed by an ever-increasing level of "preferred party" data to occupy news headlines for the first few months of 2022.

For the rest of the globe, data is likely to remain choppy, especially in the northern hemisphere where they are coming towards the end of the winter months.

The combination of strong global growth, full employment and rising inflation will require a change of settings within central banks. Despite gradual rate rises and the withdrawal of quantitative easing, strong global growth should still favour risk assets. However, pockets of excessive valuations and speculative excesses remain. If nothing else, this is likely to increase volatility within investment markets and broader share market indices.

We note a growing number of stocks in the technology-laden NASDAQ index are now down 50% or more.

Was that a canary I heard chirping?

A challenging investment environment lies ahead.

The Madness of Markets

Major price tops in markets are characterised by record merger and acquisition activity. Global dealmaking exploded in 2021 to a record $US5.8t, up 64% from the previous year and the fastest growth since the mid-90s. This was the result of the flood of money supply from central bank policies, record low interest rates, government support and surging stock markets. In 2021 a total of 334 SPAC deals were announced, raising a massive $600bn. ("SPAC's", or Special Purpose Acquisition Companies, are where a company is created or listed on an exchange specifically for the purpose of acquiring or merging with another company).

There have been significant losses in several areas of the market. A Goldman Sachs index of non-profitable US tech stocks is down 35% from its recent high. The "safety hedge" of Bitcoin is down 32% in USD since its recent high (vs gold which was flat over the same period) and Tesla, the darling of the tech sector, fell 27% from its high (CEO Elon Musk also sold US $16bn of his own shares during November and December). Afterpay fell 32% over the last quarter as its new parent, Block Inc, experienced similar falls. ETF technology fund, Ark, is also down 49% since its February 2021 high. Yet the S&P index is up 27% for the 12 months to December, highlighting that stock selection and active management will be required to preserve capital in a more volatile and dispersive environment.

Rivian is perhaps the best example of investment madness. This is a company that, as of November, had delivered a total of ~150 electric trucks and has a valuation of ~US$58bn. Now that's a lot of blue sky!

Many veteran investors hope this is just the end of the silly phase with the severity of the declines in the riskiest trades indicating that "peak insanity" is behind us. According to Doug Ramsey, Chief Investment Officer at The Leuthold Group: *we think 2021 has earned its place in the books as the wildest and most speculative year in US stock market history, eclipsing even 1929 and 1999. That doesn't mean 2022 will bring a panic or a crash, maybe just a degree of sobriety.*

Jeremy Grantham, veteran asset manager and notable bear, describes US stocks as being in a "super bubble". He predicts an eventual plunge of 50%, with the correction already underway. Grantham calls this kind of "crazy investor behaviour" (meme stocks, a buying frenzy in electric vehicle names, the rise of nonsensical cryptocurrencies such as dogecoin and multimillion-dollar prices for non-fungible tokens) as indicative of a late-stage bubble and believes bonds to be one of the greatest bubbles of all time.

For our client portfolios, whilst our stance remains positive yet protective, diversification to navigate the current environment remains paramount.

3. Asset Class Review

3.1 Equities

Global equity markets generated solid returns in 2021, with the MSCI World ex Australia Index up 29.5% for the calendar year. Growth stocks have been standout performers over the past few years with valuations supported by a negative real discount rate. As bond rates start to rise due to inflation, pressure has started to mount on these excessive valuations, (especially vs. value stocks **Figure 7**) which are normally measured by a multiple of revenue.

Within international equities, the US market looks the most expensive after years of outperformance. This has been led by a narrow number of mega cap technology companies that have benefited from the inflows of capital to index ETFs and a declining discount rate. Earnings growth across the globe will subside from the elevated levels seen in 2021 (**Figure 8**). We prefer non-US stocks currently, with a focus on cyclicals and value. Expect an increase in volatility as market (and consumer) expectations around inflation and bond rates continue to fluctuate. Portfolios will require a steady hand to avoid the emotional rollercoaster that such volatility can invoke.

Australian equities, dominated by the banks and materials, look reasonably well placed given the support expected for commodities. More broadly, the pent-up demand (in the form of household savings rates) due to rolling lockdowns should also provide a backstop for corporate earnings in Australia.

Figure 7: Growth stocks remain expensive relative to value stocks. Something to watch as bond rates start to rise in anticipation of rising interest rates which will impact the valuations of many growth stocks.

Source: JP Morgan Asset Management

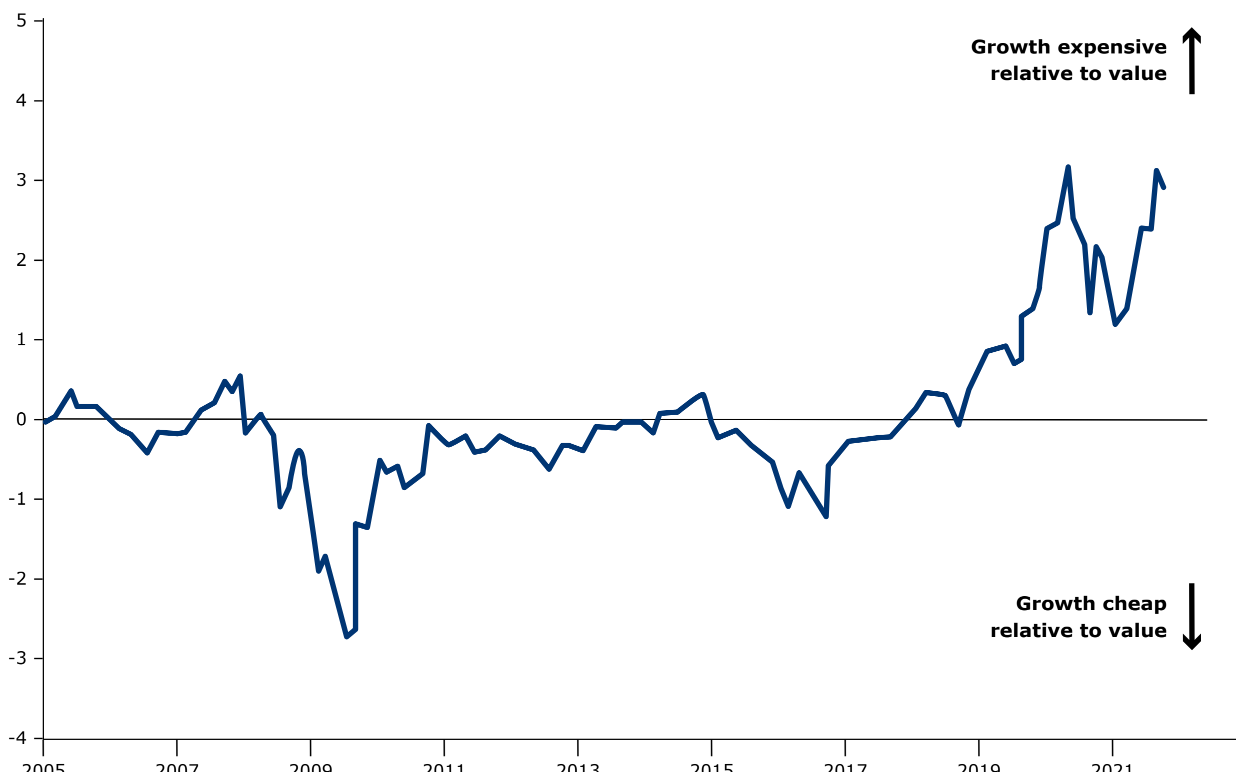
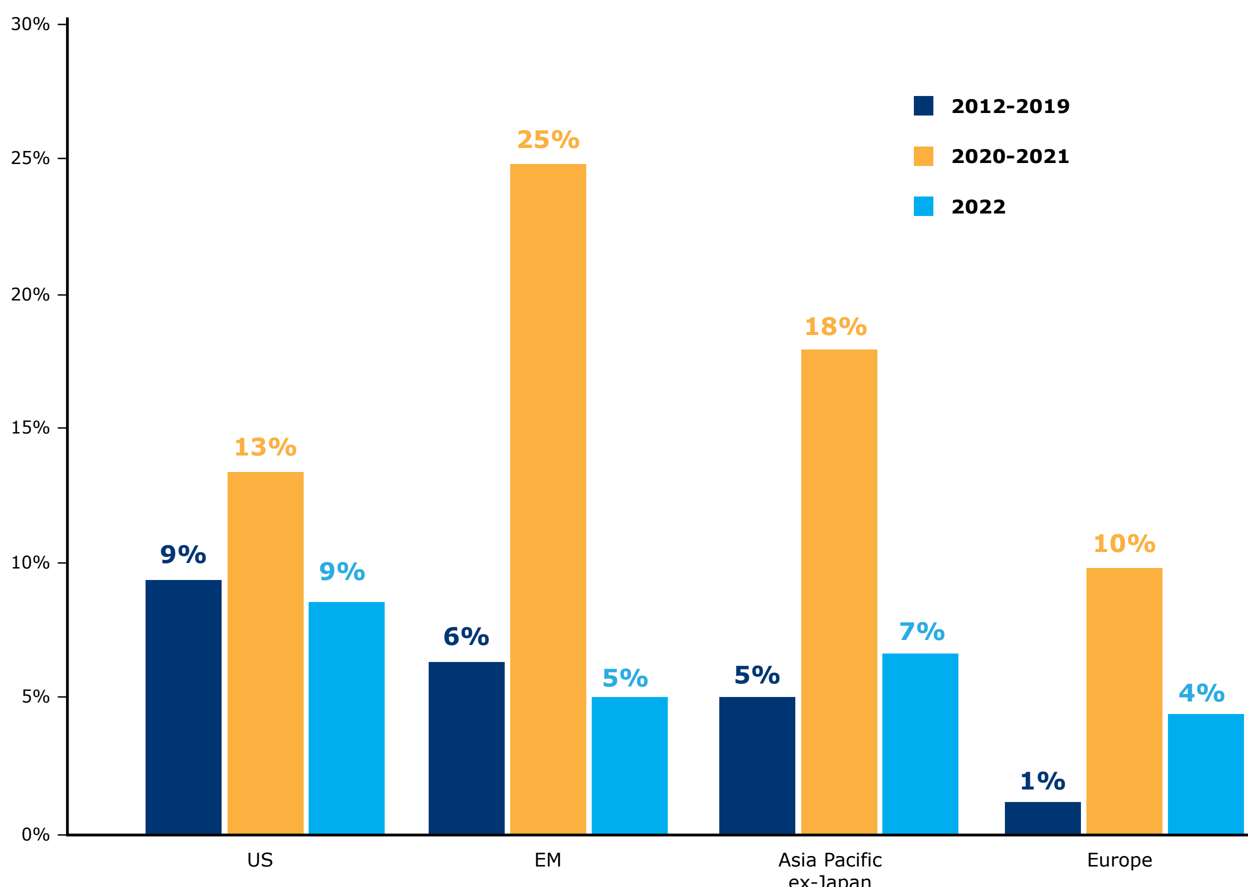


Figure 8: After a solid bounce in 2020-21, global corporate earnings will subside to more recent (2012-2019) levels. Europe is an exception after corporate earnings struggled post the GFC.
Source: JP Morgan Asset Management



3.2 Property

An unexpected boom in residential property over the past 12 months has seen values rise ~21% across Australia. We did not see that coming in the middle of a global pandemic. Quite extraordinary!

Within the non-residential property space, cap rates continue to compress in many instances and valuations remain strong. Industrial property, in particular, appears very expensive. There remains significant uncertainty regarding the demand and vacancy for office space and how a post-Covid office environment may look. Selective retail remains our preferred option, driven by the attraction of suburban retail and the emergence of some of these sites as mini distribution centres for online retailers. Landlords can still attract rental income from online sales that move through the retail centre. The demise of well-located "meeting spaces" backed by a large grocery supermarket is premature. There is also some inflation protection to be had via rental reviews and food price inflation.

We are attracted to some boutique, niche sectors within property, specifically specialist disability and social housing and regional hospitality. We are yet to be convinced that the offshore experience with build-to-rent translates the same here in Australia.

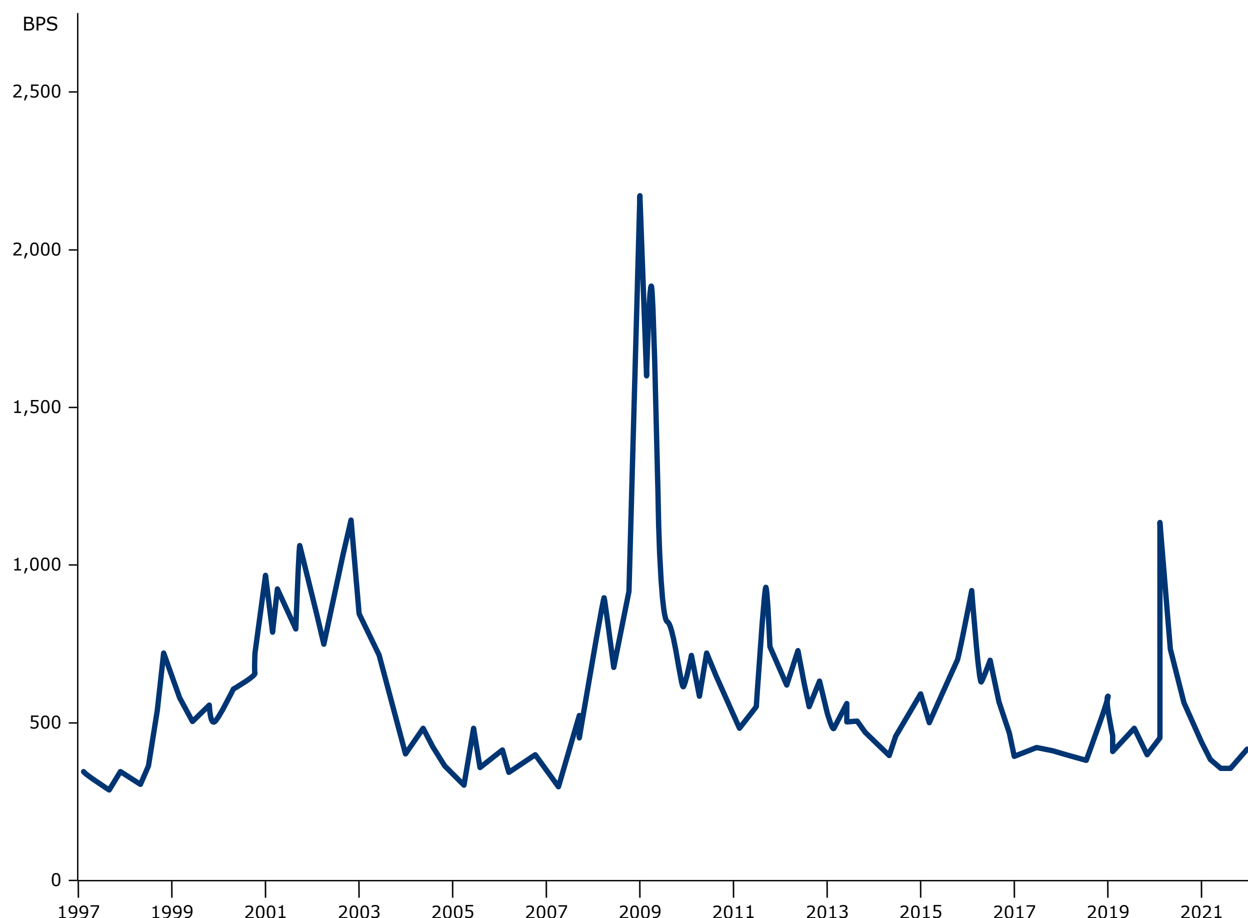
A-REITs reflected a more favourable "valuation" based investment approach throughout the year, with the overall index performing strongly. Again, our preference remains for "stock picking" and traditional property income within the broader A-REIT investment universe, rather than index investments that are dominated by funds management income.

3.3 Fixed Income

We remain underweight global government bonds and credit. This reflects our concern about higher than anticipated inflation and the impact of central banks unwinding quantitative easing (from emergency settings also). We retain Australian Government bonds to provide some portfolio protection in the event of a severe downturn. This enables us to retain an overweight stance to growth assets (positive yet protective). Credit spreads have remained exceptionally tight (**Figure 9**), and we are not convinced you are being compensated for the risk taken.

Figure 9: Credit spreads continue to remain exceptionally tight, raising the question whether an investment in this space warrants the risk.

Source: Heuristics Investment Systems



We prefer exposure to equity risk (with a value bias) vs credit. Corporates have accumulated significant debt; covenant ratios have declined in quality and interest rates are likely to move upwards. Although global growth should support earnings, the risk of higher interest rates and wage costs could erode margins. We prefer asset-backed, first mortgage loans, to enhance income.

3.4 Alternatives

We separate our alternative investments into defensive alternatives and growth alternatives. The distinction being linked to their purpose in portfolios. Our defensive alternatives aim to reduce portfolio volatility through negative-to-low correlation to traditional asset classes. Growth alternatives provide an exposure to investments that carry a similar risk to traditional growth assets, but that cannot be accessed through publicly traded markets.

Our defensive alternatives exposure broadly achieved its objective with investments in agricultural land, relative value fixed income and gold all providing diversifying qualities to traditional investments. While bond yields remain low, we expect allocations to diversifying alternatives to play an increasingly important role in diversifying portfolios.

Most growth alternatives have much longer maturity profiles, so it is too early to comment on their performance. However, the arbitrage between public equity and private equity has diminished with valuation differences between them, narrowing. We continue to manage the ongoing maturity profile of investments in private equity and venture capital to ensure investments don't mature at the same time. We remain attracted to market neutral strategies that have demonstrated uncorrelated performance with equity-like returns.

4. Conclusion

Positive but protective.

In such an uncertain environment with the prospect of higher inflation and interest rates, we believe the focus should be on value with a high level of diversification across and within asset classes. Falling interest rates and the creation of money supply has provided an exceptional period of performance in certain pockets of markets. This tailwind has abated, replaced by the headwinds of higher inflation and interest rates, which will challenge stretched valuations.

4.1 Opportunities

- Niche direct property
- First mortgage property loans
- Value over growth
- Stock selection over index selection

4.2 Risks

- Persistently higher inflation
- A bond market sell-off (leading to higher yields)
- Loss of investor confidence
- Higher than anticipated central bank response in raising interest rates
- Impact of collapsing property market in China
- Geopolitical uncertainty over Russia's intentions in Ukraine

4.3 Implications

- An increase in volatility
- Renewed focus on risk adjusted returns
- A high level of diversification will be required to weather the potential storm
- A challenging investment environment

Asset Class	Strategic*	Range	Tactical	Overweight/ Underweight
Australian Shares	23%	20% – 50%	22%	Neutral
International Shares	26%	10% – 40%	26%	Neutral
Property	11%	0% – 25%	9%	Underweight
Infrastructure	n/a	0% – 20%	5%	n/a
Government Bonds	35%	0% – 50%	12%	Underweight
Corporate Bonds/Credit	0%	0% – 50%	0%	Neutral
Cash (term deposits)	5%	2% – 50%	12%	Overweight
Alternatives/Hedge Funds	n/a	n/a	14%	n/a

** Strategic Benchmark is the Lonsec Balanced Strategic Asset Allocation, updated in August 2020

Thoughts from a Contrarian

Inflation is a topic we've covered several times in the past. It's worth covering one last time as it's unlikely to be an appropriate topic for contrarian discussion going forward. The consensus is coming around to the idea that central banks have lowered interest rates to zero, printed trillions of dollars and, not coincidentally, prices have gone through the roof. It seems printing money causes inflation. It's implausible that so few realised this. More likely, we turned a blind eye because asset price inflation hardly feels like punishment to those of us who own assets. Now the inflation that's been rampant for over a decade is finally starting to show up in the CPI. This takes some doing. The CPI basket is put together by government appointees with a vested interest in low balling the number. Economists have been telling us for years that the CPI has been going nowhere. I don't know about the theoretical 'consumer', but my personal price index has been increasing for years. Maybe it's because I include things like the cost of running my home in my cost of living.

It's likely the CPI will continue to surprise us going forward. The ability of companies to disguise price increases through 'shrinkflation' (where products reduce in size while prices stay the same) and lower product quality has reached its limits, as has the ability of central banks to torture the statistics to low ball inflation numbers. Going forward, companies will have to pass on cost increases and the CPI will have to reflect it. It will be difficult to move the theoretical 'basket' even further away from reality.

It seems the fun part of inflation, where asset prices increase, is behind us and the unpleasant part has begun. The cost of living starts to rise, and higher interest rates take an axe to asset prices. Pundits seem in agreement that we will likely see a series of interest rate rises in 2022. At least there's one last contrarian angle to this story because we've seen this movie before. The Federal Reserve attempted to raise rates a few times pre pandemic. On each occasion talk of higher rates triggered a market sell off and the Fed backtracked. Now, asset prices are even more inflated and debt levels, higher. If raising rates was difficult before it must be close to impossible now. Central banks are stuck in a trap, entirely of their own making, where they simultaneously have to raise rates and can't raise rates. My guess is they'll fold on rate rises again and seek to control inflation through direct price controls. I know it seems highly unlikely but so did QE and zero rates not so long ago.

The view expressed in this article is an independent view and does not necessarily represent the views of Providence

Providence Investment Committee

Stephen Christie

Steve has over 20 years' investment and finance experience, including as Director and Head of Private Wealth for Ord Minnett, Chairman of the Ord Minnett Investment Committee and Head of Asset Allocation for Goldman Sachs JBWere Private Wealth Management. Steve holds a PhD in Applied Finance, is an Honorary Fellow at Macquarie University, an Adjunct Professor at Notre Dame University Sydney and a Trustee Director of major industry super fund QSuper.

Steven Crane

Steven has over 40 years investment experience having started in financial markets in the early 1970s. He has held such positions as Senior Portfolio Manager and member of the Asset Allocation Committee at AMP. For seven years he was the Chief Executive of ABN Amro. His current directorships include, Chair of NIB Holdings limited, APA Group, Bank of Queensland and Transfield Services.

David Croll

David has over 20 years' experience in stock broking and funds management. He has held such positions as a dealer on the options trading floor and manager of the branch office network for stockbroker Rivkin Croll Smith in Melbourne. Since 1998, he has managed several private companies involved in options trading and investment in listed and unlisted equities. He is currently the Managing Director of Noontide Investments Ltd. He has a Bachelor of Arts majoring in Politics from Macquarie University

Chris Grubb

Chris has held senior Fund Management and Broking positions within the Jardine Fleming Group in Japan, Hong Kong and Singapore. He was a Director of Jardine Fleming Ord Minnett and Chairman of Investor's Mutual and Investor Web and is currently a Director of several Asian-focused investment funds. He also chairs Boardroom Australia and is a Director of Boardroom Limited, Singapore. Chris also acts as an executive coach.

Peter Hooker

Peter has over 25 years' experience in investment markets including Industrial Analyst at BZW Australia (now ABN Amro), and Director reporting to Head of Research. He was on the Equities Executive Committee and Director and Head of Industrial Research. He has a B.Sc. in Chemistry, B.E. in Chemical and Materials Engineering, and Graduate Diploma in Finance and Investment.

Justine Morton

Justine has 25 years of investment and finance experience both in Australia and internationally. Prior to joining Providence she was a Relationship Manager at Credit Suisse Private Banking. Justine started her career in Perth at First State Fund Managers (Colonial) then Hartley Poynton before moving to London. At Lehman Brothers and then Cargill Investor Services she focused on event arbitrage and special situations before returning to Australia, to start and run Finsbury Capital Advisors. She has a Bachelor of Commerce from UWA.

Richard Nicholas

Richard has over 30 years' experience in private client portfolio management in London, Hong Kong and Australia. Richard started his career with Deloittes in London before cutting his investment teeth with the Rothschild family. He was the founding research director at S&P Fund Research UK and Investment Director at Hill Samuel Pacific in Hong Kong. He has also held senior positions with Hambros Pacific in Hong Kong, Alliance Capital in Asia and ANZ Private Bank. He is currently director at Peak Investment Partners.

Michael Ogg

Michael has over 20 years' experience in investments, starting his career at JPMorgan Investment Management in London in the early 90s. In Australia, Michael worked for AMP Asset Management holding senior roles in institutional equities and for Deutsche Bank as a Client Advisor in Private Banking. Michael has an MA (Honours) Economics from Aberdeen University.

Providence Investment Committee

Jonathan Pain

Jonathan has 30 years' international investment experience. He has held such positions as Chief Investment Strategist of HFA Asset Management, Chief Investment Officer of Rothschild Australia Asset Management, Head of Investments at Gulf International Bank in Bahrain and Chair of the International Asset Allocation Committee at Paribas Asset Management in London. He holds a joint honours degree in Economics and Politics from Keele University and a Masters degree in the Economics of Finance and Investment from Exeter University.

Grant Patterson

Grant has over 30 years' experience in equity markets. Prior to forming Providence, he was a Director of ABN Amro and Head of Retail Broking. He has also held other senior positions such as Senior Institutional Dealer, Head of the Sydney Institutional Dealing Desk and Head of Corporate Liaison.

Will Porter

After joining Providence in 2012, Will spent two years in London to gain insight into global developments in Asset Allocation and to review alternative investment opportunities, primarily hedge funds and structured products. During this time he met with 600 different investments managers and reviewed approximately 1500 strategies. As Head of Investment Strategy, he is responsible for asset allocation, portfolio construction research and development and investment performance monitoring. Will completed a Bachelor of Commerce in 2007 and a Master's degree in Applied Finance in 2019.

Stephen Roberts

Stephen has over 40 years of experience as an economist and financial markets strategist in banking, broking and funds management. He has worked as Chief Economist with Equitilink and UBS. He worked on the Secretariat of the Australian Financial System Inquiry (Campbell Committee) in 1980, helping draft recommendations that led to the deregulation of the Australian financial system. He is an honours graduate in Monetary Economics from the London School of Economics.

James Smith

James has over 20 years' investment market experience (cash equities). Prior to joining Providence, he held the position of Deputy Head of Domestic Sales at CIMB Securities (Australia) and was a member of the CIMB Equities (Australia) Management Committee. He has also held positions as Director - Sales at RBS, ABN AMRO and Sales at Deutsche Bank. James was responsible for Melbourne Sales/Account management in his previous roles over the last decade and in the last two years, was also responsible for New Zealand. James also sits on the Benetas Investment Committee as an external adviser.

Marc Wait

Marc has over twenty years of investment experience. He began his career in Sydney with HSBC and Citigroup Global Asset Management (CGAM) managing Fixed Income and Money Market portfolios. Marc has also held positions in London with CGAM as a Fixed Income Portfolio Manager and Fidelity International where he was the Group Leader, Short Dated Bonds and chaired the Fixed Income Asset Allocation meetings for the firm. Marc was subsequently the Head of Treasury at the Abu Dhabi Investment Authority. Marc has a B.Agr.Ec (Honours) from the University of Sydney and is a Chartered Financial Analyst.

Ian Wenham

Ian has over 30 years' experience in equity research, investment strategy and portfolio management. He has held such positions as Equity Analyst with Meares and Philips and Research Director of BZW Australia covering equity strategy and industrial research. He was also Regional Research Director with BZW Asia and Director of Asian Research at Lehman Brothers Asia where he chaired the Investment Policy Committee and was the firm's Supervisory Analyst for the Asia-Pacific Region. He has also managed strategic global equity investments for the Lowy Family Private Fund. He currently heads his own investment firm..

Glossary of Terms

Term	Definition
Alpha	The level of outperformance relative to a benchmark
Credit Spread	The margin paid over the risk-free rate (government bonds)
Cyclically Adjusted Price Earnings Ratio (CAPE)	The price of a security or index divided by the moving average of ten years of earnings, adjusted for inflation
Economy-agnostic	Unlikely to be impacted by the fluctuations in the economic cycle
Fiscal Stimulus	Increasing government spending or reducing tax levels to stimulate and/or support economic growth
GDP	Gross Domestic Product - a measure of an economy’s total output
Gearing	A measure of how much debt a company has relative to equity
GFC	Global Financial Crisis
High-Yield Corporate Debt	Debt issued by a corporation that has a credit rating that is below investment grade
Inflation	When the inflation rate is above zero and the general price level of goods and services increases
Leverage	An alternative term for gearing i.e., a measure of how much debt a company has relative to equity
Monetary Policy	The process by which a country's monetary authority (usually a central bank) controls the supply of money. Traditionally by setting short-term interest rates
Net Asset Value (NAV)	The value of an entity’s assets less the value of its liabilities
Non-Correlated	An asset class that does not move in a similar direction to another asset class
PE Ratio	Price Earnings Ratio - the share price divided by the earnings per share of the company
Populism	A belief that the majority of a population is being mistreated by a small circle of elites
Sovereign Bond	A bond issued by a government
Volatility	The degree of variation of a price over time

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PROVIDENCE WEALTH

We help our clients to unlock the benefits and purpose of their wealth by providing bespoke investment strategies that honour the legacy they aim to create.

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Safe Passage

SYDNEY
Level 9, 20 Martin Place Sydney NSW 2000
PO Box R536 Royal Exchange NSW 1225
T +61 2 9239 9333

MELBOURNE
Level 30, 101 Collins St
Melbourne VIC 3000
T +61 3 8793 8383

www.providencewealth.com.au
info@providencewealth.com.au